



## **A Status Report on the U. S. Economy: How is the Elephant Doing?**

**Speech by Robert D. McTeer Jr., President and CEO of the Federal Reserve Bank of Dallas, Keynote speaker at the conference Economic Trends in Canada and the U. S., Montreal Economic Institute, May 30 2002.**

### **MICHEL KELLY-GAGNON (EXECUTIVE DIRECTOR, MONTREAL ECONOMIC INSTITUTE)**

Mesdames et messieurs, ladies and gentlemen, I hope you all enjoyed your meal. Before I briefly introduce Mr. Paul Massicotte, one of our sponsors of today, I wanted to take one minute to tell you how I got in touch with Mr. McTeer. He had written an op ed piece in *The Wall Street Journal* about Frédéric Bastiat, à propos donc de Frédéric Bastiat, qui est un auteur économiste français des années 1850 qui a été presque complètement oublié du monde francophone, mais qui était un des plus grands penseurs et philosophes économiques, en fait j'ai déjà dit que, et monsieur McTeer en fait a développé l'expression, que Frédéric Bastiat est le Adam Smith du monde francophone. Mais, malheureusement, comme le monde francophone n'est pas très encore pénétré des idées d'Adam Smith, c'est un penseur qui est à peu près inconnu.

L'Institut économique de Montréal, en l'honneur de la visite de monsieur McTeer, a fait un petit dépliant d'une cinquantaine de pages intitulé Frédéric Bastiat, défenseur du bon sens économique. Cette brochure est en vente à la sortie. Je vous la recommande, c'est une belle lecture, une lecture amusante, une lecture drôle. Même pour les gens qui ne sont pas spécialisés en économie, c'est une façon fantastique de s'initier à la pensée économique d'une façon qui est vraiment merveilleuse. But I also wanted to say that Mr. McTeer has graciously offered, he made a 40-minute speech about Bastiat in France, in Dax, where Bastiat was born, for the 200th anniversary of the birth of Bastiat. Et ce discours donc de monsieur McTeer, grâce à la magie de la technologie, d'ici environ deux à trois semaines, peut-être un mois, sera disponible sur le site Web de l'Institut économique de Montréal en format Real Player. Donc, je vous invite à venir visiter notre site Web, site Web qui a maintenant 30 000 visiteurs par mois, qui est donc le [www.iedm.org](http://www.iedm.org).

We're happy that Mr. Massicotte will now be presenting Mr. McTeer. Mr. Massicotte has been on the board of directors of the Bank of Canada for almost seven years now. He is here today in his function of president of Alexis Nihon Group. His group is an important real estate group in Quebec and possibly Canada. So, without further ado, Paul, the microphone is to you.

### **PAUL MASSICOTTE (PRESIDENT, ALEXIS NIHON GROUP & MEMBER OF THE BOARD OF THE BANK OF CANADA)**

Merci, Michel. Mesdames, messieurs, ladies and gentlemen, my name is Paul Massicotte, as you know, and I'm president of Groupe Alexis Nihon. It is a great pleasure to be here today to introduce this latest conference of the Montreal Economic Institute. After only three years in operation, the MEI has done such a good work that it was described a few weeks ago by the Secretary of State for International Finance Institutions, Mr. Maurizio Bevilacqua as, quote, "this very prestigious institute". No doubt today's conference will add to this prestige and influence.

As president and CEO of the Federal Reserve Bank of Dallas since 1991, and a member of the Board of Governors of the Federal Reserve System, our speaker today, Mr. Robert McTeer, is part of this little group of powerful people of the U.S. Central Bank. Their decisions can have

momentous consequences for the U.S. and Canadian economies, and a likelihood that a recession will happen and how long it will last. More than that, Mr. Bob McTeer is not a typical central banker. He has, over the past couple of years, become the Fed's most vocal advocate for the New Economy, and he gained international prominence for extolling the marvels of the technology boom.

The decision in 1999 to stand alone twice against his colleagues of the Open Market Committee and vote not to raise interest rates made him a central figure in the ongoing debate over the appropriate monetary policy. Mr. McTeer was already predicting quick recovery last year, and now this upturn seems to be strongly on its way, I am sure he will have some interesting reflections to share on this debate and on how, as he says in the title of his speech, the elephant is doing.

You should also know that Bob McTeer expresses his opinions not only in "serious" speeches, like this one today, but in a more poetic form. His poems can be found on the Dallas Fed Web site, and here is his latest one, a limerick on the subject of the economic recovery entitled 'Bad Timing':

There was once an economy on the ropes  
That kept dashing our recovery hopes.  
When we made the concession  
To call it a recession,  
It turned up, and we felt like dopes

C'est donc avec un très grand plaisir que nous recevons aujourd'hui monsieur Robert McTeer, un homme aux multiples talents. Accueillons chaleureusement monsieur McTeer!

#### **DR. ROBERT D. McTEER JR. (PRESIDENT & CEO, FEDERAL RESERVE BANK OF DALLAS)**

I'd better watch what I put on my Web site. I'm glad he didn't choose the one that started off "I read the personals every now and then/To see what is desired by women seeking men". In case you're wondering, mainly they want... something that's very unfortunate, they want height and weight to be proportionate, which is a problem for me.

It's good to be here, it's my first time in Montreal, and I haven't been to Canada all that much, as a matter of fact. I'm from Texas, at least the last 11 years, and I'm closer to the Tex/Mex border than I am the U.S./Canadian border, but we're all part of the NAFTA family, and it's really good to be here.

I hope the title is not offensive in any way, the program says it's a status report on the U.S. economy, "How is the Elephant Doing". That sort of originated last fall, when a Canadian delegation came to Dallas, led by your prime minister, and I gave a talk to them about sleeping with elephants, and how unfortunate it is sometimes when the big economy gets into trouble and it brings the others down with it.

In October of 2000, I was visiting the Bank of Mexico, the Central Bank in Mexico City. We do that periodically at the Dallas Fed, and we give them presentations on how the U.S. economy is doing, and they give us presentations on how the Mexican economy is doing. And in October of 2000, they were very very concerned that the U.S. was going to slip into a recession. And they explained that if the U.S. had a recession, the Federal Reserve would be free to fight the recession with easy money, but that Mexico wouldn't have quite as much freedom to do that if they caught the recession from us, given its history of high inflation and a weak currency, the Central Bank would have to remain pretty tight, even during a recession. So I think they were very eager that it not happen. I assured them that we were not going to have a recession, so not to worry. Lately, I've been looking for a nice Mexican wine that goes well with crow.

Before I go on, I should say that Canada does not have that problem. While our economies are tied closely together and while what happens in one certainly affects what happens in the other, you have a history of monetary stability that leaves you as free to pursue appropriate policies for your domestic economy, as we are in the United States. It works better for both pulling in the same

direction, and it's in the right direction, but you don't have to pay for past policy sins with inappropriately tight monetary policies, as some countries do.

I might say parenthetically that Mexico has made great strides in overcoming that burden. Last year, its inflation rate was the lowest on record, its debt is now investment grade, according to all the writings agencies, and even though it's had a recent recession that it caught from us, it had it without a financial panic for the first time. Of course, it did catch the recession from us, but that's getting a little ahead of the story.

Later in that same month, October 2000, we learned that the third-quarter growth in the United States had slowed slightly from its very fast pace in the first two quarters, first half of 2000 in the United States. And in the next two months, that third-quarter estimate was revised downward twice. And it wasn't until late December that it became clear that the third quarter had slowed fairly significantly and that the fourth quarter, which wasn't quite over yet, had apparently slowed even more than that. The fourth quarter 2000 and the first two quarters of 2001 turned out to show very weak but positive growth in the U.S. Of course, that's an average. You know, on average, the Great Lakes never freeze.

What we were having was a fairly sharp and abrupt slowdown in investment spending, especially investment in high-tech equipment and software. The engine of rapid growth in the late 1990s had hit a wall rather suddenly. Consumption spending, a much larger fraction of the economy, continued to grow slowly, so consumption grew while investment shrank. Services grew, spending on services grew while manufacturing shrank. So we got a concentrated pain, but not widespread pain.

The third quarter of 2001 would have been more of the same, slow but positive growth. Then came September the 11th, which, in about three weeks remaining in September, was sufficient to tip real GDP into negative territory. The decline for the quarter turned out to be 1.3 per cent at an annual rate. That turned out rather unexpectedly though to be the only negative quarter that we've had. The fourth-quarter rebound came in at a plus 1.7-per-cent annual rate, more than offsetting the decline in the third quarter.

The investment bust caught us by surprise, even though the high-tech sector of the stock market had crashed earlier in the spring. The stock market and the economy seemed disconnected, and still does to a large extent. As I recall, many major industrialized economies, especially European economies, expected to avoid the downturn altogether.

When the U.S. Federal Reserve System started cutting short-term interest rates aggressively, beginning on January the 3rd of 2001, that's an interesting date because it was not one of our regularly-scheduled meetings, it was a telephone conference that we did. When we started cutting rates aggressively in 2001, the ECB was slow to join in. But with hindsight, it now looks like the major economies have been moving pretty much together in recent years, both up and down. Mexico, our other NAFTA partner, was something of an exception. They say that when the United States catches a cold, Mexico gets pneumonia. And that turned out to be the case.

Our slowdown before the downturn was transmitted to Mexico as a recession. That's largely because our trade with Mexico is concentrated in manufacturing, the sector hardest hit. Our sustained consumer spending and spending on services didn't help them very much. Parenthetically, Mexico has more than one saying about the United States. One of them is "Mexico, so far from God, so close to the United States." You probably have some sayings about us as well. But I won't ask what they might be.

It appears that the Canadian economy and the U.S. economy moved pretty much together. We slowed pretty much together, we both had a negative third quarter of 2001, and we both have been recovering since then.

The Federal Reserve System cut short-term interest rates 11 times last year, bringing our target Fed funds rate down from 6.5 per cent at the beginning of the year to 1.75 per cent at the end of

the year. The Bank of Canada cut short-term rates ten times, for a total reduction of 375 basis points. One difference is that we've held rates down so far this year, while the Bank of Canada raised its target rate 25 basis points in April.

Our recoveries began rather unexpectedly in the fourth quarter last year, or at least ours was unexpected. I'm the optimist in the Fed, and I wasn't that optimistic. Our real GDP grew at a 1.7-per-cent annual rate in the fourth quarter, and a 5.6-per-cent annual rate in the first quarter. Yours grew at a two-per-cent and about a 4.5-per-cent rate in those two quarters. But your numbers may be more solid than ours. Slower inventory liquidation in the first quarter boosted our headline GDP number substantially in the first quarter. Real final sales were actually slower in our first quarter than they were in the fourth quarter. Your employment growth seems to be more vigorous than ours at this stage of the recovery.

I hope it doesn't last, but so far, our rebound bears some resemblance to the so-called jobless recovery that we had following the 1990-1991 recession. Our unemployment rate continued to drift up for more than a year after the recession was officially declared over. It peaked back then at 7.8 per cent. Last month, our unemployment rate rose to six per cent.

Both recoveries, in their initial stages at least, were powered by productivity growth, that is growth in output per hour worked, rather than by employment growth.

When unemployment is high, productivity growth is a mixed blessing. I'd just as soon growth be powered by re-employment of unemployed workers until full employment is restored, and then have productivity growth kick in. But for the longer term, the recent growth in productivity in the United States augurs well.

The key factor behind the new economy period of the late 1990s was a doubling of productivity growth from the anaemic rate of the previous two decades. The surge in productivity growth in the late 1990s - and by the way that first set of graphs in the earlier program this morning showed that while Canadian productivity growth had lagged behind U.S. productivity growth, it was almost equal in the late 1990s, which I think is a very good sign - the surge in productivity growth in the late 1990s allowed wages to rise without increasing unit labour costs. It allowed our economy to grow faster with less inflation. And it allowed unemployment to go much lower with less inflation. And it also allowed monetary policy to be easier without inflationary consequences.

The good news for the long term is that productivity in the United States continued to grow during our slowdown and the brief downturn. And it has surged in the two quarters of recovery, increasing at an annual rate of about 5.5 per cent in the fourth quarter last year and increasing over eight per cent in the first quarter. It was announced at 8.6, that will probably go down a couple of notches with the revision in GDP. It'll probably be somewhere around 8.4. This suggests that once the recovery is complete, growth and inflation may well look more like the late 1990s than the more sluggish earlier period.

As I understand it, Canadian productivity growth was not quite as strong as ours through most of the 1990s, but yours also held up well last year, especially for a recession year.

Other economic variables also moved pretty much in sync in our two countries. Your inflation record has been consistently better than ours, a credit to your central bank, and, some would say, its policy of inflation targeting. Unemployment is traditionally higher in Canada, for reasons of climate and the weather I assume, but the gap has narrowed considerably in the past couple of years. Your unemployment has gone down relative to ours. Canadian unemployment has not gone up as much as U.S. unemployment during this recent slowdown. Ours has gone from around four per cent to six per cent. Since unemployment is a lagging indicator, I suspect it will rise a bit more before turning down.

Your fiscal balance has pretty much mirrored ours in recent years, moving from significant deficit to surplus. But your surplus seems to be holding up a little bit better than ours is. The combination of the slowdown and the build-up of government spending, especially since September the 11th, has

taken its toll. Not all our loss of fiscal discipline can be explained by these two factors, however.

I've had a special interest in your exchange rate for many years, but I'm afraid I have no special knowledge of why the two dollars have diverged so far in recent years. I did my Ph.D. dissertation in the 1960s on flexible exchange rates and the idea that they permitted more independent domestic monetary policy and that they helped insulate the domestic economy from foreign shocks, something called a shock absorber this morning, and I used the Canadian experience with floating exchange rates in the 1950s as a case study. I learned then, and I've continued to realize, that your central bank has always been innovative and on the leading edge of economic theory and policy. Its anti-inflation credentials are better than ours over quite a period, which should result in a stronger dollar.

I asked our economists before I came here to look into why the Canadian dollar has been so weak in recent years. They reported back it's a mystery. The cause of strength of the U.S. dollar until recently is a mystery to me as well. And maybe that's where we ought to be looking for the explanation. Both Canada and Europe, not to mention Japan, have had better inflation records than we have, although ours has improved substantially in recent years. We've run large trade and current account deficits for many years. The proximate answer to the mystery is capital inflows into the United States that have more than offset the trade deficit, pushing the exchange rate up. But that sort of begs the question.

Back to our prospects for continued recovery. I suspect that the current quarter, or the second quarter, of 2002 will come in somewhere between the fourth quarter and the first quarter, as inventory swings become less important or less prominent in the United States. But we need to have investment rebound. The consumer can't continue to carry the whole burden of a U.S. recovery. And for investment to rebound, we need for-profit prospects to improve. We can't have a profitless recovery, although there has been some recent improvement in profits.

Both these things may be beginning to happen. Certainly the strong productivity performance will help restore profits as it pushes unit labour cost down. Whichever of our economies emerges the stronger in the coming months will help the other out of the ditch, given our large trading relationship. Despite recent unpleasantness, we do have the largest trading relationship in the world, averaging 1.3 billion dollars of trade per day. U.S. trade with Canada is 50-per-cent larger than it is with the next largest trading relationship. And U.S./Canada trade has more than doubled under the Free Trade Agreement and NAFTA. And I believe it's increased 60 per cent since 1994.

As soon as we're over this low bump in the road, I'm sure our two countries will continue to grow and prosper together.

Thank you very much.

### **MICHEL KELLY-GAGNON**

Alors, nous allons avoir une brève période de questions, nous avons environ une dizaine de minutes. Alors, pour permettre au plus grand nombre de participants possible, prière d'avoir des questions qui soient les plus courtes possible et de vous identifier. Il y a monsieur Leblanc, mon collègue Patrick Leblanc, qui est avec un micro, comme Jerry Springer, il se promène avec le micro dans les mains. Mais nous serons sûrement un public plus discipliné. Alors donc, si vous avez des questions, vous avez tout simplement à lever la main, et monsieur Leblanc va aller vers vous. Évidemment, vous posez la question en anglais, s'il vous plaît.

### **CLÉMENT GIGNAC**

My name is Clément Gignac. I know the Federal Reserve was pretty happy with the productivity number and the inflation, but we have inflation from time to time outside the consumer price index, like inflation in commodities, inflation in tangible assets, like real estate, and so on. And so

what is the role and how does the monetary policy cope with inflation when the inflation is outside the CPI and comes from tangible assets? And how do you deal with that?

### **ROBERT McTEER**

So far, we have... our official position has been that we try to have price stability or close to price stability in the current production of goods and services. The consumer price index, the producer price index and two or three other price indexes all give you slightly different readings on that. The consumer price index is actually showing us to be doing the worst job, but it's not been bad.

So far, we haven't decided that it's the Central Bank's responsibility to try to influence asset prices directly, to try to curb what might appear to be a bubble in the stock market, or to try to do anything specifically regarding, say, for example, a housing market boom or bubble. Academic economists continue to debate whether central banks ought to be involved in that sort of thing, but so far, our position is it's only the prices of currently-produced goods and services, and we allow the market to take care of the rest of it. That may change some day, but it hasn't yet.

### **ROY CULLEN, DÉPUTÉ**

Yes, my name is Roy Cullen, I'm a member of Parliament in the House of Commons in Ottawa, and this may be more of a political question, and I apologize if it comes across that way, but, well, you've talked a lot about NAFTA, but there's a lot of evidence to suggest right now that there's a huge protectionist policy building in the United States, and that surely, from an economic perspective, has an economic cost to Americans, I think, and to Canadians.

Do you see this as something that is sort of transitory given the congressional and senatorial elections, or is this signs of a policy developing in the United States which is more, I would submit, inward looking and damaging, or is it something that is just a phase, or are we going to be with this for some time to come, this protectionist mood in the United States?

### **ROBERT McTEER**

I have to step carefully here. I don't know what he said a while ago about Frédéric Bastiat, the French economist who, you might say, is the French Adam Smith. He first came to most people's attention with something called the petition on behalf of the candle makers. He wrote this fictitious petition to the French Parliament on behalf of the French candle makers in the 1840s, urging the passage of a law that would require everybody to shut their windows and their blinds and their shuttles to close out the sunlight, because the sunlight was providing unfair competition to the candle industry in the economy, and he pointed out all the advantages to the candle industry and related industries, including the merchant marine industry, and thus national defence, if only it would shut out the sunlight. This was a brilliant piece of economic analysis that's never been refuted.

The only person better than Frédéric Bastiat in extolling the virtues of free trade was an economist named Henri George, who once pointed out that protectionists want to do to their own country in peacetime what the country's enemies want to do to it during wartime - that is close its borders to imports. I'm a free-trader. The academic community, the economic community everywhere are free-traders. If you ask economists to make a list of things that economists most agree on, my contention is that free trade would be at the top of that list.

And yet, they keep having to win the debate over and over. They win it and then it slips away. Part of the reason is that the advantages of protectionism are very visible, the people that are helped by it know who they are, they know the laws that need to be changed to help them, and they're focused and active.

The beneficiaries of free trade are many many more, but they're all helped just a little bit, and they generally aren't even aware of what's going on. So it makes it a very tough sell.

A couple of years ago, I heard a song on the radio, a country song, where I get most of my wisdom. It's called "Three chords and a truth", sung by Sarah Evans. It seems that her boyfriend, they must have had an argument or something, had finally convinced her with three chords and the truth. And I immediately thought of our problem of free trade, and that is that we've had the truth since Adam Smith, what we've needed is the right three chords, and we haven't gotten it yet.

Protectionism is always just under the surface, I don't think it's increased significantly in the United States, but it's unfortunately, what happened, I regret it. And I suspect that give us a chance, we'll come back to our roots on that. I probably said too much rather than too little.

## **MARC GODIN**

Mr. McTeer, Marc Godin. The obvious question now, this morning we heard the Canadian point of view on dollarization and common currency. So if the Canadian dollar is such a great deal, then the U.S. being a free trader economy, why not taking over it. What's your view and what's the sentiment right now in the U.S. for a common currency with the NAFTA partners?

## **ROBERT McTEER**

Yes. Well, let me make it clear that the Federal Reserve System has no view on dollarization. It's not what we do. That's a matter for the U.S. Treasury.

The Dallas Fed did have a conference on dollarization about two years ago, and the context of that though was Latin America, particularly Argentina, whether they would benefit. In retrospect, you know, maybe they should have done that a couple of years ago, before they lost control. And there was a little bit of emphasis on whether Mexico might do it. My job at the conference was to listen to all the speeches and see if I could summarize the consensus at the end of the conference. I did it with a limerick.

There once was a hyperactive central banker  
That needed a stronger anchor  
The ocean was big, his boat was small  
So he tied his anchor to a tanker.

That's sort of neutral sounding, I realize. I believe that if you have major countries with a good history of monetary stability and with credible central banks and sensible policies generally, I believe that flexible exchange rates are the way to go. If you have one country though that's smaller, with not such a good record over time, with not such good credibility in being able to stave off inflation, it might be that for the smaller country, they might do better to either anchor to a tanker and accept the monetary policy of a bigger, wiser central bank. I don't know if any such country exists right now, but I have a hard time putting Canada in that position. I don't have a position on it, but I think Canada is perfectly capable of doing its own monetary policy.

The recent weakness of the Canadian dollar notwithstanding, if it were linked to the U.S. dollar in some really strong way, then, whatever the forces are pulling down the Canadian dollar would manifest themselves some other way, and possibly in a way that's less, less tolerable than the decline in the dollar. So it's none of my business, if any country wants to use the dollar domestically as their currency, it's all right with me. The Federal Reserve will continue to conduct monetary policy based on economic conditions in the United States, and for many countries, that might give them a better monetary policy than they're getting. But we would not be in a position to change monetary policy because of somebody who is being towed behind our boat.

I will say though that at this conference, we had Senator Mack, a senator from Florida at the time, there, who was a proponent of dollarization in general, and who had introduced a bill before

Congress that would reimburse a country that officially dollarized for about 80 per cent of its lost seignorage, the sort of implicit income that it gets for having its own currency. So there are people that believe that dollarization is something that the United States ought to negotiate with other countries about. But to my knowledge, nobody is pushing that right now.

By the way, I'm not going to cash in my Canadian money, I'm going to hold it for the next time.

Thank you very much.

### **MICHEL KELLY-GAGNON**

Bob, you may want to stay not too far because I think Mr. Fournier will want to be with you on the podium pretty soon.

Je veux simplement mentionner aux journalistes, je sais qu'il y a plusieurs journalistes qui sont présents, après le mot final de monsieur Pierre Fournier, M. McTeer sera disponible pour un bref scrum dans la salle à côté. Donc, for the accredited journalists, media, I know we've had a lot of requests, Mr. McTeer will be available in the room at the side in a few minutes.

So thank you again, Bob, for your comments and remarks, and thank you for having accepted our invitation.

I will now invite Mr. Pierre Fournier to conclude today's event. Mr. Fournier is executive vice-president and managing director, financial studies, at the National Bank Financial. As I have said earlier, the National Bank Financial is our co-sponsor of the day. Again, I want to thank them sincerely for their support. I will now let Mr. Fournier make the final remarks.

### **PIERRE FOURNIER (VICE-PRÉSIDENT EXÉCUTIF ET DIRECTEUR GÉNÉRAL, ÉTUDES FINANCIÈRES, FINANCIÈRE BANQUE NATIONALE)**

Alors, en notre nom à tous, je voudrais vous remercier, Monsieur McTeer, pour votre allocution. We have had a sample here today of why Robert McTeer has acquired a worldwide reputation as president of the Federal Reserve Bank of Dallas. Astute, always outspoken, often controversial, even though he's been quite well behaved today, Mr. McTeer is undoubtedly the most modern of the Federal Reserve presidents. His down-to-earth common-sense approach to the economy and monetary policy has frequently challenged the conventional wisdom and the economists who continue to espouse outdated theories. You have always been an unequivocal supporter of free trade. Let's hope that you can convince your president to practice what he preaches on that front.

After having heard you today, and many of us for the first time, it is not hard to understand why so many serious observers in the U.S. and elsewhere strongly support your candidacy to replace Alan Greenspan as chairman of the Fed.

Finally, again, on behalf of all of us, allow me to present you with a small token of our appreciation.

### **ROBERT McTEER**

Just kidding, Alan.

### **PIERRE FOURNIER**

Merci, thank you.